

**Office of Chief Counsel  
Internal Revenue Service  
memorandum**

Number: **201515017**

Release Date: 4/10/2015

CC:FIP:B04:RLBaxter  
POSTF-120081-14

Third Party Communication: None  
Date of Communication: Not Applicable

UILC: 832.00-00, 832.06-01

date: December 22, 2014

to: Reid M. Huey  
Associate Area Counsel (St. Paul)  
(Large Business & International)  
Attn: Teri Jackson

from: Donald J. Drees, Jr.  
Senior Technician Reviewer, Branch 4  
(Financial Institutions & Products)

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subject: Reinsurance Recoverable

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

**LEGEND**

Insurance Company =  
Date 1 =  
\$X =  
\$Y =

**ISSUES**

Whether the Service may challenge a taxpayer's estimate for reinsurance recoverable under Internal Revenue Code § 832(b)(5)(A)(iii) separately from a determination regarding the reasonableness of the taxpayer's unpaid loss reserves under § 832(b)(5)(A)(ii).

**CONCLUSIONS**

The Service may challenge a taxpayer's estimate for reinsurance recoverable under § 832(b)(5)(A)(iii) separately from a determination regarding the reasonableness of the taxpayer's unpaid loss reserves under § 832(b)(5)(A)(ii).

## FACTS

Insurance Company (the “Taxpayer”), a property and casualty insurer, reported an allowance for uncollectible reinsurance recoverable at Date 1 of \$X. Taxpayer’s consolidated unpaid loss reserves at Date 1 was \$Y. In the current audit cycle, the Service has chosen not to examine whether Taxpayer’s reserves for unpaid losses under § 832(b)(5)(A)(ii) are a fair and reasonable estimate of the amount the taxpayer will be required to pay. The Service, however, is challenging the amount reported as uncollectible reinsurance used to determine the estimated reinsurance recoverable under § 832(b)(5)(A)(iii).

## LAW AND ANALYSIS

Insurance companies subject to tax under § 831 are required to determine gross income under § 832(b)(1). Section 832(b)(1)(A) provides that one of the items taken into account in gross income is the combined gross amount earned during the taxable year from investment income and from underwriting income computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners. The term “underwriting income” is defined in § 832(b)(3) as “the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred.”

Section 832(b)(5) provides, in part as follows:

- (A) In general. The term “losses incurred” means losses incurred during the taxable year on insurance contracts computed as follows:
  - (i) To losses paid during the taxable year, deduct salvage and reinsurance recovered during the taxable year.
  - (ii) To the result so obtained, add all unpaid losses on life insurance contracts plus all discounted unpaid losses (as defined in section 846) outstanding at the end of the taxable year and deduct all unpaid losses on life insurance contracts plus all discounted unpaid losses outstanding at the end of the preceding taxable year.
  - (iii) To the results so obtained, add estimated salvage and reinsurance recoverable as of the end of the preceding taxable year and deduct estimated salvage and reinsurance recoverable as of the end of the taxable year.

The amount of estimated salvage recoverable shall be determined on a discounted basis in accordance with procedures established by the Secretary.

Treas. Reg. §1.832-4(a)(14) provides in computing losses incurred the determination of unpaid losses at the close of each year must represent actual unpaid losses as nearly as it is possible to ascertain them.

Treas. Reg. §1.832-4(b) provides:

(b) *Losses incurred*.—Every insurance company to which this section applies must be prepared to establish to the satisfaction of the district director that the part of the deduction for “losses incurred” which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses... These losses must be stated in amounts which, based upon the facts in each case and the company’s experience with similar cases, represent a fair and reasonable estimate of the amount the company will be required to pay. Amounts included in, or added to, the estimates of unpaid losses which, in the opinion of the district director, are in excess of a fair and reasonable estimate will be disallowed as a deduction. The district director may require any insurance company to submit such detailed information with respect to its actual experience as deemed necessary to establish the reasonableness of the deduction for “losses incurred.”

Treas. Reg. §1.832-4(c) provides that under § 832(b)(5)(A), losses incurred are computed by taking into account losses paid reduced by salvage and reinsurance recovered, the change in discounted unpaid losses, and the change in estimated salvage and reinsurance recoverable. For purposes of § 832(b)(5)(A) (iii), estimated salvage recoverable include all anticipated recoveries on account of salvage. Estimates of salvage recoverable must be based on the facts of each case and the company’s experience with similar cases.

Taxpayer argues that the Service may not challenge the amount reported as uncollectible reinsurance because Taxpayer’s net amount calculated under § 832(b)(5)(A)(ii) and (iii) are in the aggregate fair and reasonable. It is anomalous to hold that the Service can only challenge the reasonableness of the entire amount of losses incurred but not any portion that makes up the whole amount.

Although the Code and regulations do not expressly define reinsurance recoverable, § 832(b)(5)(A) and Treas. Reg. §1.832-4(b) and (c) provide that reinsurance recoverable is included in the calculation of losses incurred. Therefore, the scope of the term “reinsurance recoverable” must be interpreted in accordance with the rules applicable to losses incurred. See Blue Cross and Blue Shield of Texas, Inc. v. Commissioner, 328 F.3d 772 (2003) (same argument for salvage recoverable).

Treas. Reg. §1.832-4(b) provides, in part, that the district director may require any insurance company to submit such detailed information with respect to its actual experience as deemed necessary to establish the reasonableness of the deduction for losses incurred. Since reinsurance recoverable is part of losses incurred, reinsurance recoverable must not only be reasonable but is subject to examination by the Service. Accordingly, the Service may challenge a taxpayer’s estimate for reinsurance recoverable under § 832(b)(5)(A)(iii) separately from a determination regarding the reasonableness of the taxpayer’s unpaid loss reserves under § 832(b)(5)(A)(ii).

In addition, reinsurance recoverable in § 832(b)(5)(A)(iii) includes balances due from reinsurance companies for paid and unpaid losses and loss expenses that will be recovered from reinsurance based on the contractual arrangement between the taxpayer and the reinsurer.

Treas. Reg. §1.832-4(b) states “that the part of the deduction for ‘losses incurred’ which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses...stated in amounts which, based upon the facts in each case and the company’s experience with similar cases, represent a fair and reasonable estimate of the amount the company will be required to pay.” Therefore, if collection of reinsurance is or becomes reasonably doubtful, because of the impairment or insolvency of the reinsurer, the regulations—at least in the case of an unpaid claim—require such reinsurance to be eliminated in the computation of losses incurred. Because the unpaid loss must be stated in the “actual” amount that “the company will be required to pay,” it should not be reduced for reinsurance that is unlikely to be collected.

The same standard of reasonableness should apply to paid losses as it does to unpaid losses. The application of different standards for reinsurance on paid and unpaid losses would necessitate senseless income adjustments at the point at which the standard changes i.e., when the loss is paid, even if the original loss and reinsurance estimates ultimately prove correct. It would also be anomalous to require a higher standard for excluding uncollectible reinsurance after a loss is paid than before the loss is paid; reinsurance recoverable with respect to the reasonable likelihood of recovery should be the relevant measuring rod in either case.

Finally, Taxpayer’s argument that the Service may not challenge the amount reported as uncollectible reinsurance because Taxpayer’s net amount calculated under § 832(b)(5)(A)(ii) and (iii) are in the aggregate fair and reasonable ignores Treas. Reg. §1.832-4(c). If, as Taxpayer argues, the estimate of salvage and reinsurance recoverable is rolled into the general “fair and reasonable standard” of Treas. Reg. §1.832-4(b), then there would be no reason to have a discrete standard for estimated salvage recoverable in Treas. Reg. §1.832-4(c).

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 317-4435 if you have any further questions.

cc: Internal Revenue Service  
Attn: Industry Director, (LB&I:RFTH)  
Retailers, Food, Transportation & Healthcare  
1901 Butterfield Road, Suite 310  
Downers Grove, IL 60515